MADISON INVESTMENTS INSURANCE SOLUTIONS

June 30, 2024 | Separately Managed Account Investment Strategy Letter

THE FED CONTINUES WITH HIGHER FOR LONGER WHILE MARKET PARTICIPANTS QUESTION POLICY

The back-and-forth debate between the Federal Reserve and the markets over when rate cuts should begin continued through the second quarter of 2024 as inflation moderated and economic growth continued, albeit at a more moderate pace.

The U.S. economy is expected to show moderate growth in the second quarter of 2024, with GDP projected to grow at an annual rate of 2.1% in Q2 2024, up from previous estimates of 1.5%. This indicates stronger economic performance than initially anticipated. The unemployment rate is forecast to remain steady at 3.9% in Q2 2024, suggesting a stable labor market despite earlier concerns about potential weakening. Job gains are expected to continue to be robust, with forecasters predicting an average of 200,000 new jobs per month in the quarter. Inflation remains a concern, with consumer prices projected to rise at a 3.4% annual pace in Q2, up from 1.8% in Q4 2023. This indicates persistent inflationary pressures despite the Federal Reserve's efforts to bring inflation down to its 2% target. Overall, the second quarter 2024 economic outlook appears more positive than earlier forecasts, with stronger GDP growth and job creation, stable unemployment, and ongoing inflation challenges.

Based on their latest projections and statements, the Federal Reserve is expected to ease monetary policy in the second half of 2024. The Fed is likely to begin reducing the federal funds rate from its current target range of 5.25-5.50% to 5.00%-5.25%, possibly as early as September. The Fed will carefully assess incoming data, the evolving economic outlook, and the balance of risks before making any adjustments to the target range. The Fed remains committed to returning inflation to its 2% objective and will not reduce rates until it has gained greater confidence that inflation is moving sustainably toward this target. While the Fed sees risks to achieving its employment and inflation goals as becoming more balanced, it remains highly attentive to inflation risks and uncertainties in the economic outlook, opening the possibility of further delays if inflation proves to be stubborn. The Fed's actions in the second half of 2024 will ultimately depend on incoming economic data and the evolving economic landscape.

U.S. investment grade fixed income markets had mixed performance in the second quarter of 2024: The Bloomberg Intermediate Government Credit Bond Index, a broad measure of the U.S. investment grade bond market, ended the period with a return of 0.64% quarter to date and 0.49% year to date. Treasury yields rose slightly, with the 10-year Treasury yield ending 19 basis points higher at 4.39% after reaching a high of 4.70% in late April. Investment-grade corporate bonds saw decelerating inflows, suggesting weaker demand compared to earlier in the year. Overall, it appears US investment grade fixed income faced some headwinds in Q2 2024, with modestly rising yields and negative returns for broad market indices. However, yields remained relatively attractive.

For our insurance clients with equity market exposure, the U.S. equity market demonstrated strong performance in the second quarter of 2024, continuing the positive momentum from earlier in the year. The S&P 500 index showed a 4.27% increase from April 1 to June 28, 2024. Companies reported better-than-expected first quarter earnings growth of 6% year-over-year, with projections for 9.3% growth in the second quarter. Year to date, the return on the index was 15.9%. Communication Services and Utilities sectors led earnings growth, while Materials, Healthcare, and Energy sectors faced challenges.

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Investors remained optimistic about lower inflation, earnings growth acceleration, and anticipated interest rate cuts in the latter half of 2024. Election headlines will begin to dominate investors' radars as the summer progresses. Presidential election year returns have historically been positive, regardless of the party affiliation of the victorious candidate.

Looking forward to the second half of the year, within the fixed income sector, we expect agency mortgage-backed securities to continue to offer attractive opportunities. We like taxable municipal bonds despite tighter spreads, due to their stability of credit quality should we see a slower economy. High-quality corporate bonds also offer some opportunities for diversification. Concerning portfolio duration, we continue to lengthen out towards a neutral stance versus benchmarks and lock in yields not seen in a decade and a half. We also foresee the yield curve steepening with the short end declining in anticipation of further rate cuts and the long-end staying within the current range of 3.80%-4.50%.

Don Miller *Bill Fain*

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In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond’s maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Bond Spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

Yield Curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward sloping curve), inverted (downward sloping curve) and flat. Yield curve strategies involve positioning a portfolio to capitalize on expected changes.

A basis point is one hundredth of a percent.

Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. Duration measures how long it takes, in years, for an investor to be repaid the bond’s price by the bond’s total cash flows.

High yield bonds are considered lower-quality instruments known as “junk bonds”. Such bonds entail greater risks than those found in higher-rated securities.

Upon request, Madison may furnish to the client or institution a list of all security recommendations made within the past year.

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